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The State of the U.S. Economy: Near Term Challenges and Long Term Changes

It is a pleasure to be here today to discuss the state of the economy, not least because -- despite some turbulence of late in financial markets -- there is still good news to report. We are now in the eighth year of economic expansion. Production, employment, and incomes have all been rising briskly, and the unemployment rate has declined to its lowest level since 1970. And at the same time, inflation has remained remarkably subdued.

But the prudent central banker cannot afford to focus exclusively on the good performance of the past. He must constantly look as well to the future. In that spirit, today I shall not only discuss our current economic situation, but I shall also comment on several areas that I believe deserve particular attention in the period ahead. Some of these areas involve potential risks to our fine economic performance, and some involve potentially important structural changes to our economy.

Before I begin, let me remind you that these views are personal and do not necessarily reflect the views of other members of the Federal Open Market Committee or the Board of Governors.

Recent Economic Performance
As you know, the United States has been experiencing a period of exceptionally strong economic growth. Real GDP rose nearly 4 percent over 1996 and again last year, the fastest rates of increase, two years in a row, in fifteen years. And activity maintained a rapid pace of expansion over the first half of this year as well, although growth apparently did step down some in the spring. This recent performance is especially impressive because it occurred in the face of a substantial reduction in export demand associated with the crisis in Asia.

This powerful economic growth has benefited American businesses through soaring profits. It also has benefited our governments -- federal, state, and local -- through tax revenues that have come in above earlier expectations. And it has benefited American workers, through higher incomes and lower unemployment rates than almost anyone predicted. Our tight labor markets have had the tremendous dividend of giving job experience to people who otherwise would be on the margins of the economy -- experience that will serve these people well for many years to come. Tight labor markets are welcome, even to central bankers, where they can be sustained without producing cost and price pressures that will undermine prosperity.

The driving force behind this sustained growth has been domestic demand, as reflected in enormous increases in both consumption and investment spending. Consumption spending has been fueled by rapid growth of employment and incomes. With some 6 million people added to payrolls over the past two years, and with compensation gains well in excess of inflation, consumers have had the means to boost their spending appreciably. And the more than doubling in the value of the stock market since late 1994 -- only a small fraction of which has been reversed in recent weeks, I might add -- has made people more comfortable about spending out of current income -- and probably out of accumulated assets, too. It should be no surprise that surveys that measure consumer confidence have recorded historic highs, nor that the personal saving rate has declined considerably. The same factors, along with the lowest mortgage rates in some time, have powered home sales to record levels.

Favorable financial conditions, along with exceptionally large price declines for computer equipment, have made it relatively cheap for firms to invest in new plant and equipment. And with sales in a solid uptrend, this has produced a remarkable boom in capital spending. Business fixed investment was up nearly 10 percent last year, and it rose at a still faster pace in the first half of this year. Even more strikingly, investment has averaged 10 percent annual growth over the past five years, making this the most rapid sustained expansion of investment in thirty years. As I shall discuss shortly, this investment may provide reason for some to be optimistic about productivity growth in the period ahead. But, without doubt, it has played an important role in helping to boost aggregate demand in recent quarters.

One important question looking forward is whether the recent rapid growth in demand can be sustained. I am not a forecaster, but it is important to know what the consensus among forecasters has been, and most have been expecting growth to slow from its recent pace. One reason forecasters have expected growth to slow is that production for inventories had been rising at an extremely rapid pace that was unlikely to be maintained. And indeed, inventory investment did drop down a good bit in the second quarter, contributing importantly to that quarter's more modest GDP growth. Still, most analysts believe that the rate of stockbuilding -- at least outside the motor vehicle sector -- probably remained unsustainable and can be expected to slow further.

A second reason forecasters have expected a slowdown is that the impetus to consumer spending from annual gains of 25 to 30 percent in share values seemed unlikely to be sustained. This may seem obvious after last month's drop in stock prices, but looking back to earlier in the year even the most optimistic forecasters were expecting stock market increases well short of the rates seen in 1996 and 1997. The impetus to spending from such modest increases in household wealth would be considerably smaller than was generated by last year's outstanding run-up in share prices. And of course, last month's decline may provide further reason to expect consumption growth to slow.

International Risks

A third important reason forecasters have expected slower growth ahead is the continuing troubles overseas. The problems faced by our Asian trading partners, including the persistent weakness of the Japanese economy, and the accompanying strength of the dollar, already have led to a sharp reduction in the demand for our exports. Indeed, in the first half of this year, the quantity of exports declined two quarters in a row for the first time since the mid-1980s, with shipments to Korea and Japan down sharply. Declines in exports of machinery, industrial supplies, and agricultural equipment were especially noteworthy. When we include the effect of rising imports as well, net exports subtracted more than 2 percentage points from GDP growth over this period, and our trade deficit on goods and services widened to about $175 billion at an annual rate in the second quarter.

I should emphasize that not all of the effects on our economy of the Asian crisis have been adverse. Low prices this year of energy and other internationally traded commodities, including many agricultural commodities such as soybeans and wheat, have benefited much of our nation -- although certainly not our oil industry or our farmers. Those low prices reflect, in part, a decline in the demand from Asia. To put it another way, those nations exporting oil and other commodities have borne some of the brunt of the sagging Asian economies. Furthermore, the favorable financial conditions in this country may have been aided by a "flight to safety" that helped hold down our long-term interest rates and stimulate interest-sensitive sectors like housing. Thus, the seemingly fortuitous timing of extremely robust domestic demand that has offset the reduction in our export demand has not been entirely coincidental.

As with any financial crisis, it is extremely difficult to predict what the future will bring for the troubled Asian countries. I remain guardedly optimistic that conditions will begin to stabilize in the coming months, and that export demand will start to firm at least a little next year. But that is by no means a certainty.

One particular risk is that the problems that have thus far been most severe in Asia may become more severe in other regions of the world. We have already seen this in Russia, and financial difficulties in other countries as distinct as South Africa and Brazil emphasize the worries and uncertainties on this score. For a variety of reasons, there could be a more "contagion" to other countries. First, investors' appetite for international risks has gone down following the Asian crises. This has led to trouble for countries that are running current account deficits and so are dependent on foreign capital. While most of Russia's problems are home grown, for example, more cautious investors probably contributed to precipitating that country's crisis. Indeed, over the last month it has become apparent that even U.S. financial markets are not immune to perceptions that risk has increased. Second, as some emerging-market countries with fixed exchange rates respond to market pressures by relaxing their exchange-rate arrangements, those remaining countries attempting to peg their exchange rates may come under increasing speculative pressures. Third, countries that have close economic ties to the hardest-hit Asian nations certainly are feeling the repercussions of a reduction in demand for their exports, and a greater economic slowdown in Asia could trigger financial problems in those countries, too. And finally, as I noted earlier, countries that are heavy exporters of oil and other primary commodities have been hard-hit by low prices.

In short, international problems in Asia and elsewhere are proving to be more profound and sustained than many, myself included, were guessing and hoping would be the case. Obviously, the effect of this drag on our ongoing economic expansion is an area that deserves close scrutiny in the months ahead.

Inflation Developments

But as I noted, the flip side of reduced export demand and a strong dollar is that the international situation is helping to hold down inflation here at home. This helps to explain the remarkable fact that our strong economic growth and low unemployment rates have coincided with exceptionally favorable news on the inflation front. I cannot overemphasize the importance of this story: rising inflation has sown the seeds of almost every cyclical downturn of the last half century.

The consumer price index increased less than 2 percent over the past year. The last time consumer inflation was this low was in 1986 when, as in the present instance, consumers benefited from declining prices of energy products. But even when we exclude volatile food and energy items and focus on the so-called "core" CPI, inflation has been running not much above 2 percent, the lowest rate in more than three decades. And a broader measure of prices, the GDP price index, has increased only one percent over the past year, held down by rapid declines in the prices businesses pay for computers and communication equipment.

This inflation performance has been better than most analysts had expected. But we should not exaggerate the extent of the surprise. True, most economists believe that the current unemployment rate of 4-1/2 percent is below the level consistent with stable inflation, and indeed may already be exerting upward pressure on labor costs. But almost all sensible economists have long realized that unemployment is not the only influence on inflation. As I have emphasized, the strong dollar has led to falling prices for our imports, and low oil prices have led to low prices for gasoline and other energy products. Low oil prices also have helped hold down prices for petroleum-derived products like fertilizers and plastics, and they have reduced price pressures more generally by reducing firms' utility and transportation costs. Furthermore, structural changes in the health care system have reduced the growth of firms' health care costs. These factors have all contributed to our benign inflation performance. We will need to be vigilant because, just as these factors have worked to the benefit of low inflation recently, any or all of them may turn around and exert upward pressure on inflation in the future.

Changes in the Labor Market

One of the complexities in the inflation outlook involves changes that appear to be occurring in labor market practices. The extraordinary rise in labor demand and the accompanying tight labor markets have led to labor shortages in some parts of the country. Shortages have been reported for a variety of jobs, with the supply of computer professionals especially tight.

To some extent, firms have been responding to these labor shortages by raising wages. And indeed, compensation increases have been growing in size for the past two to three years. But firms also have responded to tight labor markets in ways other than simply granting larger base wage increases. Firms have been making increasing use of various forms of targeted pay, such as hiring and retention bonuses, as a way to attract and retain certain key employees without granting a general wage increase. These targeted bonuses seem to be most prevalent for information processing workers, but I sense that they are reasonably widespread beyond that area as well. And these bonuses are often quite sizable. It is not uncommon to hear of hiring bonuses of five to ten percent of base salary, or higher.

Firms are changing their compensation practices in other ways, too. Businesses increasingly are relying less on base wage and salary increases, and are substituting some form of variable pay that is tied directly to performance, such as annual bonuses and profit sharing plans, or even stock options that extend well beyond senior management.

These changing labor market practices have implications for the functioning of the economy that are both interesting and, potentially, quite important. For one thing, many targeted bonuses may not be adequately captured by our aggregate wage statistics, so if these bonuses are becoming more prevalent, labor costs may be rising somewhat faster than the published data would indicate. Second, these practices may lead to changes in the cyclicality of firms' compensation costs. On the one hand, if firms now are able to use targeted bonuses to certain workers in place of generalized wage increases, this could hold down compensation costs in tight labor markets, thereby making these costs less cyclical. On the other hand, increasing use of variable pay will tend to make compensation more cyclical than it otherwise would have been. Under a profit sharing system, for example, firms make larger compensation payments to their employees when times are good than they do when business is slack.

If the latter effect were to dominate, and compensation were to become more cyclical, it would raise interesting questions about how this change might affect firms' pricing behavior. To some extent, of course, firms probably smooth through the cyclical ups and downs in their costs when making price decisions in any case. But such smoothing probably is not perfect, and increases in *fixed* pay probably would exert some upward pressure on prices. Increased use of profit-sharing bonuses, however, would presumably lead firms to boost their employees' compensation precisely when they can most afford to do so. And, conversely, when profits are being squeezed, the resulting decline in bonus payments would help ease the firm's cost pressures. Thus, there may be reason to believe that increases in variable compensation payments might not lead to the same price pressures as would increases in fixed compensation payments. In other words, increased cyclicality of compensation gains might not imply any change in the cyclicality of price increases.

Finally, the spread of variable pay could lead to changes in employment patterns. Pay that is more variable is more tied to profitability. As profitability declines, so will compensation, and it is possible that employment may not drop as much as it would in a world in which compensation is less closely tied to profits. In any event, it will be fascinating to watch these labor market developments unfold, and to try to sort out the implications for the macroeconomy.

Of course, companies are not moving toward variable compensation schemes to alter the macro-dynamics of the economy. Firms are moving to variable compensation schemes because they hope these changes will enhance their profitability, in part by raising worker productivity. By giving workers a larger and more direct stake in the fortunes of the company, firms are providing incentives for their employees to work more efficiently and to suggest productivity-enhancing changes to the way products are made and business is conducted. It is hard to know how successful these efforts will ultimately prove to be. Many business people are convinced that variable compensation plans have paid off in terms of higher productivity. Many others are less confident, and say that they *hope* the changes are boosting productivity, but that it is very hard to pinpoint the sources of productivity improvements.

This discussion points to one final aspect of our economic outlook that deserves mention, namely, productivity growth. In the long run, nothing is as important for our economic welfare as productivity growth, for this is what determines the pace of increase in living standards. And the recent productivity data have been impressive: output per hour worked rose 1-3/4 percent in 1997 after an advance of more than 2 percent the year before. The big question is whether this rapid productivity growth is temporary or is permanent -- that is, whether productivity has merely displayed its normal short-run response to a step-up in the growth of activity, or whether the faster pace can be sustained for some time even as output growth moderates.

The only correct answer, of course, is that we don't know yet. I can cite a few reasons to be very cautiously optimistic that productivity may be on a more favorable uptrend than it was in the 1980s. One reason is the changing incentives within the firm owing to variable pay that I just discussed, which at least some firms strongly believe has aided their productivity performance. A second reason for optimism is the investment boom that I discussed earlier. Economic history teaches us fairly convincingly that growth in the amount of capital per worker is an important determinant of gains in output per worker.

Furthermore, some analysts have argued that the computerization of our economy is only now beginning to bear fruit, and that we may expect impressive productivity advances as people learn to use the new technology effectively. The economist Paul David notes that it took several decades following the initial development of the electric motor for companies to reorganize their production techniques to use the new invention efficiently. By analogy, David's argument hints that the largest benefits of computerization may be yet to come.

This analogy is intriguing, but counterarguments certainly can be made as well. One reason it took electric power so long to yield benefits is that it took many years for the new technology to gain widespread use, in part because of the huge expenditures required to reconfigure manufacturing plants to use electric power. By contrast, the transition from older office equipment to mainframe computers, and then to desktop machines, often entails much smaller adjustment costs and so has been comparatively rapid. Furthermore, it is easy to forget that, while computers account for a large share of investment, they account for only a small share of the overall capital stock, in part reflecting their rapid rate of depreciation. Thus, unless computers earn a considerably higher return than other investments that firms might make, the small share imposes some limits on the contribution computers could make to overall productivity growth.

So, while we can be hopeful that the recent productivity increases may represent a faster long-term trend, we should not count our chickens too soon. But you certainly can add productivity to the list of items I will be following closely in the period ahead.

Conclusion
With strong output growth, low unemployment, low inflation, and rapid productivity growth, these have certainly been good times to be a central banker. But this does not mean that they are not interesting times, as a glance at the financial pages will drive home. Although our economy is basically very strong, we also face near-term and longer-term challenges, and I hope I have given you a sense of some of the issues that will be on my mind as I try to gauge our nation's economic performance in the period ahead.

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